Office of Chief Counsel
Internal Revenue Service

memorandum

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RWDillard

date: August 5, 2002

to: Internal Revenue Service, Examination Division (LMSB)
Attn: Revenue Agent John Alfson

from: Associate Area Counsel
(Retailers, Food, Pharmaceuticals & Health Care)

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subject: [redacted]
Advisory Opinion

ISSUES

1. Whether the taxpayer's acquisition of [redacted] ("[redacted]") qualifies as a reorganization under I.R.C. § 368.

2. How should the taxpayer determine its basis in the stock of [redacted] immediately after the acquisition?

[redacted], (b)(5)(AC), (b)(7)a

[redacted], (b)(5)(AC), (b)(7)a

CONCLUSIONS

1. Yes. The acquisition qualifies as a reorganization under I.R.C. § 368(a)(1)(A) by reason of the application of § 368(a)(2)(E). The acquisition also qualifies as a reorganization under I.R.C. § 368(a)(1)(B).

2. The taxpayer can determine its initial basis in the stock of [redacted] by choosing a basis equal to (1) [redacted]'s net asset basis just prior to the reorganization, or (2) [redacted]'s shareholders' aggregate stock basis immediately before the reorganization.

FACTS

1. Background

The taxpayer, [redacted] ("[redacted]"), a Florida corporation, was formerly known as [redacted] ("[redacted]"). The taxpayer changed its name to [redacted] in [redacted].

[redacted]

The taxpayer files a consolidated income tax return.

The tax years at issue are [redacted] and [redacted]. On its Form 1120 for [redacted], the taxpayer deducted (as an ordinary loss) worthless stock of $[redacted]. The deduction represents a portion of the taxpayer's basis in the stock of [redacted], which the taxpayer acquired on [redacted].

The taxpayer claims that the acquisition qualified as a reverse triangular merger under I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(E), and as a Type B reorganization under I.R.C. § 368(a)(1)(B). The taxpayer calculated its beginning basis in the stock of [redacted] by estimating [redacted]'s shareholders' aggregate stock basis immediately before the acquisition. To estimate [redacted]'s shareholders' aggregate stock basis, the taxpayer relied on Rev. Proc. 81-70.

The taxpayer claims that the [redacted] stock became totally worthless in [redacted]. According to the taxpayer, its basis in the [redacted] stock totaled $[redacted] in [redacted]. Of the $[redacted], the taxpayer claims that $[redacted] was not disallowed under Treas. Reg. § 1.1502-20(a). The taxpayer did not deduct the worthless stock for financial purposes.

The worthless stock deduction resulted in a NOL of $[redacted] for [redacted]. The taxpayer filed a Form 1139 and carried back the NOL to [redacted] and [redacted]. The Internal Revenue Service subsequently refunded $[redacted] and $[redacted] for [redacted] and [redacted], respectively. Currently, the statute of limitations for assessment for [redacted] and [redacted] expire on [redacted] and [redacted], respectively[1].

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[1] For the [redacted] and [redacted] tax years, however, any deficiency attributable to the net operating loss carryback can be assessed

2. Taxpayer's Acquisition of [redacted]

On [redacted], the taxpayer entered into an Agreement and Plan of Merger ("the Agreement") with Sunrise Merger [redacted] ("[redacted]"), a Delaware corporation and wholly owned subsidiary of the taxpayer, and [redacted], a Delaware corporation. The Agreement provided that the taxpayer would acquire [redacted] and its wholly owned subsidiaries through the merger of [redacted] with and into [redacted] (with [redacted] surviving the merger and becoming a wholly owned subsidiary of the taxpayer).

Just prior to the effective time of the merger, [redacted] had [redacted] shares of common stock outstanding. [redacted] had no outstanding preferred stock. Additionally, the taxpayer had [redacted] shares of common stock outstanding. The taxpayer had no outstanding preferred stock. The effective time of the merger was the date and time that a Certificate of Merger was filed with the Secretary of State of Delaware.

The Agreement provided that each corporation's stock would be converted as follows:

(1) [redacted]

(2) [redacted]; and,

(3) [redacted]

The taxpayer issued [redacted] shares of its common stock to the [redacted] shareholders. The taxpayer also paid cash to some [redacted] shareholders in lieu of issuing fractional shares of its common stock. According to the taxpayer, its common stock had a fair market value of $[redacted] on the effective date of the exchange, [redacted].

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prior to the expiration of the statute of limitations for assessment for [redacted]. I.R.C. § 6501(h).

At the time of the merger, [redacted] had [redacted] wholly owned subsidiaries. Most of [redacted]'s subsidiaries provided [redacted] services, but several of [redacted]'s subsidiaries provided [redacted] services. [redacted]'s subsidiaries, and a brief description of the type of business each subsidiary was engaged in, are outlined on Exhibit A. [redacted] and its subsidiaries were part of the taxpayer's consolidated group.

3. [redacted]'s Disposition of its Subsidiaries

Shortly after the acquisition, [redacted] began to dispose of its subsidiaries. In [redacted], [redacted] merged [redacted] of its subsidiaries into one of the taxpayer's wholly owned subsidiaries. Additionally, [redacted] distributed the stock of its [redacted] companies to the taxpayer.

In [redacted], the taxpayer sold all of its [redacted] assets and businesses, and [redacted] of [redacted]'s [redacted] subsidiaries, to [redacted], a subsidiary of [redacted] of [redacted], for $[redacted]. The sale was part of a plan for the taxpayer to divest itself of its [redacted] business to focus on more profitable [redacted] services and [redacted] services. [redacted] also sold the assets of its [redacted] subsidiaries to [redacted] for $[redacted]. Finally, [redacted] dissolved one of its subsidiaries, [redacted].

DISCUSSION

Issue 1

No gain or loss is recognized by a shareholder who, in pursuance of a plan of reorganization, surrenders his stock or securities in a corporation which is a party to a reorganization for stock or securities in such corporation or in another corporation which is a party to the reorganization. I.R.C. § 354(a)(1). Similarly, no gain or loss is recognized by a corporation if the corporation is a party to a reorganization and if it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation which is a party to a reorganization. I.R.C. § 361(a).

I.R.C. § 368 defines a reorganization, which can take several different forms. One type of reorganization is "a statutory merger." I.R.C. § 368(a)(1)(A). A statutory merger is one effected pursuant to the corporate laws of the United States, a State, a territory, or the District of Columbia. Treas. Reg. § 1.368-2(b)(1). As required under I.R.C. § 368(a)(1)(A), the

merger of [redacted], a Delaware corporation, into [redacted], another Delaware corporation, was effected pursuant to the laws of the State of Delaware.

Transactions qualifying as a reorganization under I.R.C. § 368(a)(1)(A) can take several different forms. One of the forms is a reverse triangular merger, which is a statutory merger that qualifies as a reorganization under I.R.C. § 368(a)(1)(A)* by reason of the application of I.R.C. § 368(a)(2)(E).

Under I.R.C. § 368(a)(2)(E), if certain conditions are satisfied, a transaction otherwise qualifying under I.R.C. § 368(a)(1)(A) is not disqualified by reason of the fact that stock of the controlling corporation, i.e. the corporation that was in control of the merged corporation before the merger, is used in the transaction. The conditions which must be satisfied under I.R.C. § 368(a)(2)(E) are:

> (1) after the merger, the surviving corporation must hold substantially all of its properties and the properties of the merged corporation; and,
>
> (2) in the transaction, the former shareholders of the surviving corporation must exchange an amount of stock in the surviving corporation (which constitutes control of the surviving corporation) for an amount of stock in the controlling corporation.

Control is defined as 80 percent of the combined voting power and 80 percent of the number of all classes of stock of the corporation. I.R.C. § 368(c).

In this case, the statutory requirements under I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(E) were satisfied. After the merger, [redacted] owned all of its properties and the properties owned by [redacted]. Additionally, the former shareholders of [redacted] exchanged all of their stock in [redacted] for stock in the taxpayer.

The taxpayer's acquisition of [redacted] also satisfied the statutory requirements for a reorganization under I.R.C. § 368(a)(1)(B). A reorganization under I.R.C. § 368(a)(1)(B) is the acquisition by a parent (or subsidiary) of stock of another corporation in exchange "solely for voting stock" of the parent corporation where, immediately after the exchange, the parent corporation (or subsidiary) holds stock in the acquired corporation representing control of the acquired corporation. I.R.C. § 368(a)(1)(B); Treas. Reg. § 1.368-2(c).

In this case, the taxpayer acquired all of [redacted]'s

outstanding stock in exchange solely for its voting stock and, immediately after the exchange, the taxpayer controlled [redacted]. The fact that the taxpayer paid cash in lieu of issuing fractional shares of stock does not violate the "solely for voting stock" requirement of I.R.C. § 368(a)(1)(B). Mills v. Commissioner, 331 F.2d 321 (1964), reversing 39 T.C. 393 (1962); Rev. Rul. 66-365, 1966-2 CB 116. Thus, the acquisition of Career also satisfied the statutory requirements for a reorganization under I.R.C. § 368(a)(1)(B).

Finally, courts have also imposed three additional requirements for a merger to qualify as a reorganization under I.R.C. § 368. Honbarrier v. Commissioner, 115 T.C. 300, 310 (2000). The three requirements are: (1) business purpose, (2) continuity of business enterprise, and (3) continuity of interest.

The first requirement, continuity of interest, was originally created in Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), and is now embodied in Treas. Reg. § 1.368-1(b) and described in paragraph (e) of the same section. "Continuity of interest" requires that the original owners of the transferor corporation retain a continuing interest in the reorganized corporation. The requirement was satisfied in this case because [redacted]'s shareholders retained an interest in the reorganized corporation through the taxpayer's stock.

The second requirement, business purpose, was first enunciated in Gregory v. Helvering, 293 U.S. 465 (1935), and is now embodied in Treas. Reg. § 1.368-1(b) and described in paragraph (c) of the same section. "Business purpose" requires that a transaction must be disregarded if the transaction was entered into solely for tax avoidance and served no valid business purpose. In this case, we are aware of no facts that indicate the transaction lacked a valid business purpose.

The third requirement, continuity of business enterprise, was first expressed in Cortland Specialty Co., supra, and is now embodied in Treas. Reg. §§ 1.368-1(b) and described in paragraph (d) of the same section. "Continuity of business enterprise" requires that the acquiring corporation either continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business. Honbarrier v. Commissioner, 115 T.C. 300, 311 (2000); Treas. Reg. § 1.368-1(d)(2). The fact that the acquiring corporation is in the same line of business as the acquired corporation tends to establish the requisite continuity, but is not alone sufficient. Treas. Reg. § 1.368-1(d)(3)(i).

In this case, it appears that the continuity of business

enterprise requirement has been satisfied. [redacted]'s historic business was [redacted] services (primarily [redacted] and some [redacted] services). The taxpayer was also in the [redacted] business, which tends to establish the requisite continuity. Although [redacted] disposed of its [redacted] subsidiaries within [redacted] years of the acquisition, the taxpayer continued to provide [redacted] and [redacted] services (in fact, [redacted]'s [redacted] businesses were merged into one of the taxpayer's subsidiaries in [redacted]).

In light of the above, the acquisition qualifies as a reorganization under I.R.C. § 368(a)(1)(A) by reason of the application of § 368(a)(2)(E), and the acquisition also qualifies as a reorganization under I.R.C. § 368(a)(1)(B).

Issue 2

Treas. Reg. § 1.358-6 provides rules for computing a controlling corporation's basis in the stock of a controlled corporation as the result of certain triangular reorganizations, including reverse triangular mergers, one of the types of mergers. The regulation applies to reorganizations that occurred on or after December 23, 1994. Treas. Reg. §§ 1.358-6(b)(2)(iii), (c)(2)(i), (f).

In the explanation of Treas. Reg. § 1.358-6, the names P, S and T are used. P is defined as a corporation (1) that is a party to a reorganization, (2) that is in control of another party to a reorganization, and (3) whose stock is transferred in the reorganization. Treas. Reg. § 1.358-6(b)(1)(i). S is defined as a corporation (1) that is a party to the reorganization, and (2) that is controlled by P. Treas. Reg. § 1.358-6(b)(1)(ii). T is defined as a corporation that is another party to the reorganization. Treas. Reg. § 1.358-6(b)(1)(iii). In this case, P represents the taxpayer; S represents [redacted]; and T represents [redacted].

Pursuant to Treas. Reg. § 1.358-6(c)(2)(i)(A), for purposes of computing the taxpayer's basis in the [redacted] stock acquired as a result of the reverse triangular merger, the basis rules applicable in a forward triangular merger apply. Simply put, such treatment results in the taxpayer having a basis in [redacted] stock equal to the taxpayer's basis in its [redacted] stock increased by [redacted]'s net asset basis. Treas. Reg. §§ 1.358-6(c)(1), 1.358-6(c)(4), Examples 2(a)-(b).

However, because this reverse triangular merger also qualifies as a reorganization under I.R.C. § 368(a)(1)(B), the taxpayer has the option of (1) computing its basis in [redacted] stock using the basis rules for a forward triangular merger

(discussed above) or (2) computing its basis in [redacted] stock under I.R.C. § 362(b). Treas. Reg. § 1.358-6(c)(2)(ii). Under I.R.C. § 362(b), the taxpayer's basis in [redacted] stock would be [redacted]'s shareholders' aggregate basis in their [redacted] stock immediately before the merger. I.R.C. § 362(b); Treas. Reg. § 1.358-6(c)(4), Example 2(c).

Finally, where, as in this case, the taxpayer and [redacted] become members of a consolidated group after the reorganization, Treas. Reg. § 1.358-6(e) references the additional basis rules at Treas. Reg. § 1.1502-30. However, in this case, Treas. Reg. § 1.1502-30 does not apply. Treas. Reg. § 1.1502-30 only applies to (among other things) reverse triangular mergers which do not also qualify as a reorganization under I.R.C. § 368(a)(1)(B), and, in this case, the transaction also qualifies as a reorganization under I.R.C. § 368(a)(1)(B). See Treas. Reg. § 1.1502-30(b)(2).

If you have any questions, please contact the undersigned at (904) 665-1987.

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